

## The Challenges to Fiscal Leadership

- Four eras of municipal finance.
- Contemporary municipal finances
- Linking fiscal architecture and space
- Toward 'sustainable' fiscal structures.

## Four Municipal Fiscal Eras

- <u>pre-Great Depression:</u> Property-tax dependence of local governments; ownership of real estate signified wealth.
- 1929 and extending until the end of the Great Society expansion of federal programs: municipalities diversified their tax base to include retail sales; the federal government provided an unprecedented amount of funding.
- the advent of the 'tax revolt' of the late 1970s: a sudden decline in the share of property taxes; the dramatic reduction of direct federal aid to cities; rapid increase in user fees.
- The fourth era is unfolding at this very moment: from financial markets and real estate collapse an emerging new normal.

## I. Property Tax Reigns: pre-1929

- In an agrarian economy, "...wealth and property are the same things and the ownership of property is closely correlated with income or ability to pay taxes."
- States and localities were highly dependent on the property tax:
  - State governments in 1902 raised 45% of their ownsource revenues from the property tax, while for all local governments the figure was 78%.
  - In 1929, the state property tax contributed only 15% of state funds and by the post-war era, it had dropped to under 3%.

## II. The Great Depression and Revenue Diversification: 1930s to late 1970s

**1929-1933:** Unemployment nearly 1 in 4

DJIA drops 89%.

Bank failures: ~50%.

Riots in cities and agricultural areas.

Prices decline by ~ 25%

**1930-1939**: 4,770 municipal defaults.

#### Sales Tax

- New York City enacted the first sales tax in 1934 followed by New Orleans in 1936.
- 11-12% of own-source revenues by the 1960s
- By the late 1980s, sales tax revenues had reached nearly 18% of own-source revenues, where it has remained

#### Income tax

- Philadelphia (1938), St. Louis (1948), Pittsburgh (1954), and Detroit (1962)
- Since 1946, Ohio municipalities have exercised a power to levy a municipal income tax. Toledo was the first Ohio city to pass an income tax, followed in 1949 by Columbus, Dayton, and Youngstown; Cincinnati in 1954
- Income tax revenues constitute a relatively small amount of revenue compared to total municipal budgets nationwide

### Fees and Property Tax

- constant-dollar property tax revenue per capita for municipalities declined by 45% from \$456 per capita in 1942 to \$255 in 1977, while constant-dollar user fees (including enterprise funds) increased from \$252 to \$349 or a 38% increase
- Property taxes in 1942 constituted 78% of cities' own-source revenues; in 1977, 43%.

#### Feds

 federal aid to municipalities reached \$25 billion (constant dollars) in FY78, amounting to nearly 15% of general municipal revenue.

# III. Tax Revolt and Federal Withdrawal: 1978-2009

#### Fees and taxes

- the escalation of user fees from 30% to 40% of own-source revenues between 1978 and 1982
- Between 1978 and 2002, total fees and charges, including fees for enterprise-related services, jumped from \$349 per capita (constant dollar) to \$546 per capita (constant dollars), or an average annual increase of 6.5%.
- General taxes between 1978 and 2002 grew at a 3.4% annual rate.
- property tax revenue as a percent of municipal revenue, falling from 41% to 31% of own-source revenues

#### Diversity

cities with populations greater than 50,000: roughly 34% have access to the property tax only; 8% have access to the income tax (in addition to having access to the property tax); and nearly 58% have some retail sales-taxing authority.

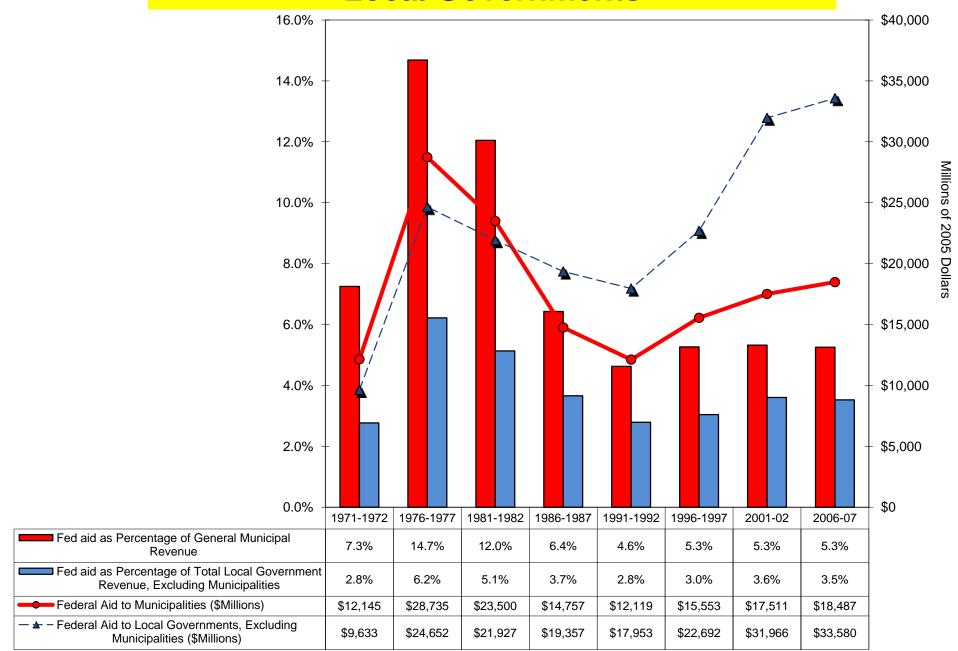
# The Changing Role of Fees and Charges in General Revenues

(Millions of 2002 Dollars)

Year	Counties	Municipalities	Townships	School districts	Special district
1972	\$15,486	\$27,647	\$1,451	\$11,399	\$11,669
1977	\$19,922	\$30,598	\$1,580	\$11,937	\$15,295
1982	\$30,261	\$43,545	\$2,638	\$16,094	\$24,482
1987	\$41,531	\$57,878	\$3,244	\$15,927	\$32,450
1992	\$49,222	\$64,462	\$4,194	\$19,410	\$35,991
1997	\$59,941	\$75,479	\$4,916	\$22,818	\$40,967
2002	\$68,288	\$80,436	\$5,335	\$26,498	\$47,070

#### State Aid to Municipalities and to All Other **Local Governments** \$400,000 40% \$350,000 35% \$300,000 30% Millions of 2005 Dollars \$250,000 25% \$200,000 20% \$150,000 15% \$100,000 10% \$50,000 5% 0% \$0 1971 1976 1981 1986 1991 1996 2001 2006 -02 -07 1972 1977 1982 1987 1992 1997 State aid as Percentage of General Municipal 24.1% 23.2% 20.8% 20.2% 21.3% 20.7% 21.9% 19.6% Revenue State aid as Percentage of Total Local 36.8% 37.6% 38.2% 36.7% 37.3% 37.8% 35.2% 38.1% Government Revenue, Excluding Municipalities State Aid to Municipalities (\$Millions) \$40,358 \$45,450 \$40,613 \$46,470 \$55,906 \$61,064 \$71,887 \$68,838 \$282,247 \$335,011 \$127,806 \$148,942 \$163,194 \$194,268 \$240,062 \$337,677 Municipalities (\$Millions)

## Federal Aid to Municipalities and to All Other Local Governments



#### **Municipal Tax Authority by State** WAe MTf ND MNf OR IDf SD WY $\mathsf{P}\mathsf{A}^\mathsf{a}$ $NJ^f$ IΑ NE NV ОН DEa INc IL UT CO KS CA MOa NC TN ΑZ $\mathsf{OK}^{\mathsf{d}}$ ARb NM GA MS ALa TX

**Notes:** a Income or sales tax for selected cities. **b** Cities can levy a local income tax, but no locality currently does so. **c** A local income tax under certain circumstances. **d** Sales tax only; cities can levy a property tax for debt-retirement purposes only. **e** Cities can impose the equivalent of a business income tax. **f** Sales taxes for selected cities and/or restricted use only.

Property + sales + income

Property + sales OR Income

Property or sales only



Source: Michael A. Pagano and Christopher Hoene, "States and the Fiscal Policy Space of Cities" in Michael Bell, David Brunori, and Joan Youngman, eds. *The Property Tax and Local Autonomy* (Cambridge, MA: Lincoln Institute of Land Policy, 2010), pp. 243-284

## IV. The Future: 2009 and Beyond?

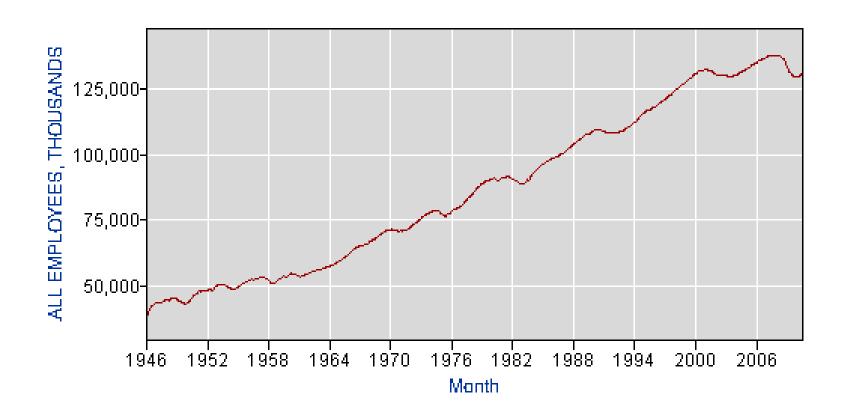
## It's not the Great Depression

- **√**~10% unemployment today *v*. ~25% in 1929-1933
- ✓DJIA down 20-30% v. decline of 89%, 1929-1933
- ✓ No riots v. urban and rural riots during 1930s
- ✓ Prices steady v. price decline of around 25%, 1929-33
- ✓ Bank foreclosures around 10% v. 50% between 1929-33
- ✓ Municipal defaults very few v. 4,770 in1930s

## but ...

- Real estate market will be slow to recover
- Consumer spending beginning to rise
- Wages steady or declining
- Household savings up
- Employment shifts. Services and 501-c-3
- State fiscal crises

**Industry**: Total Nonfarm



**Industry**: Manufacturing

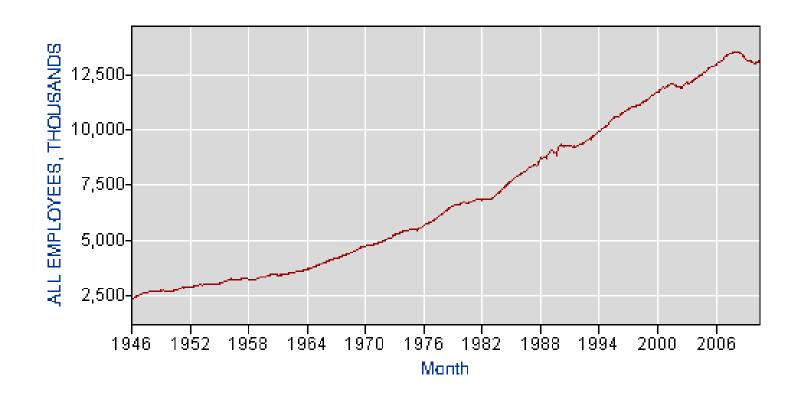




**Industry:** Service-providing

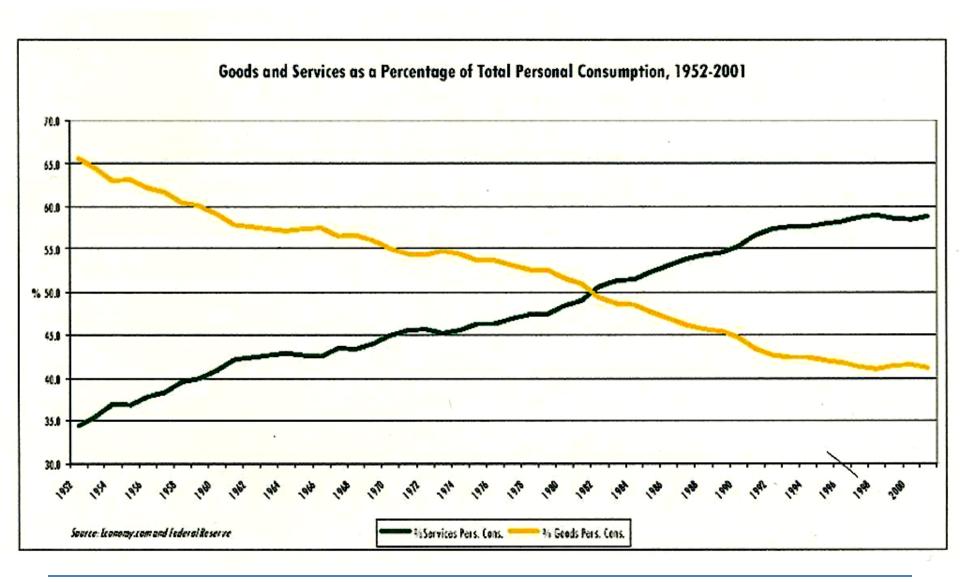


**Industry:** Leisure and hospitality





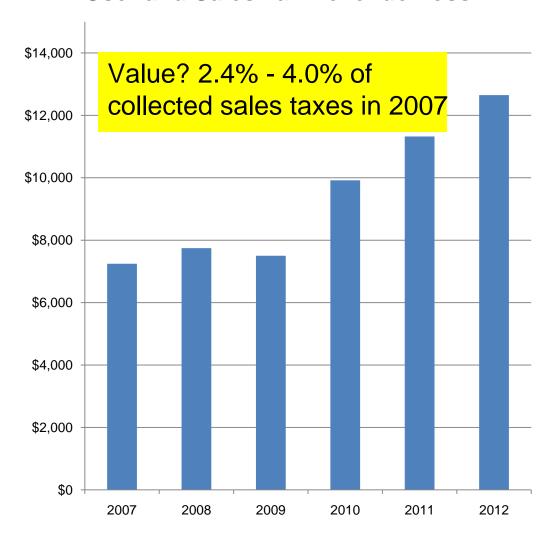
## Shift from Goods to Services





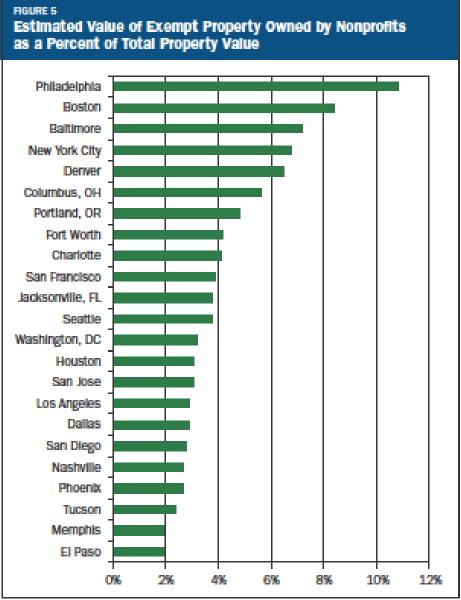


## **Estimated Total State and Local User and Sales Tax Revenue Loss**



## Growth of 501-c-3

- The nonprofit sector accounts for roughly one-tenth of the U.S. economy, whether measured by employment or total spending
- Houston recently adopted a "drainage fee" and didn't exempt 501-c-3 organizations.

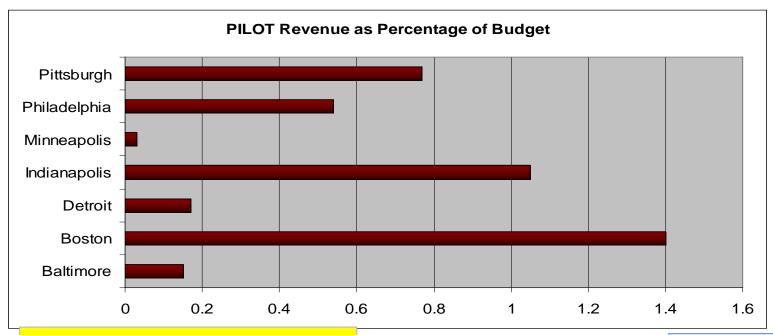


Note: These statistics should be viewed as rough estimates. Policy makers should exercise caution when drawing conclusions from these data, because the quality of assessments of exempt property is wide-ranging and often unreliable (Lipman 2006b).

Source: Lipman (2006a).

Source: Daphne A. Kenyon and Adam H. Langley, *Payments in Lieu of Taxes:*Balancing Municipal and Nonprofit

Interests (Cambridge: Lincoln Institute of Land Policy, 2010).



Che New York Cimes

States Move to Revoke

Charities' Tax Exemptions
(February 27, 2010)

Provena-Covenant Medical Center v. (Illinois)Dept. of Revenue (2010) (Estimates For FY2000)

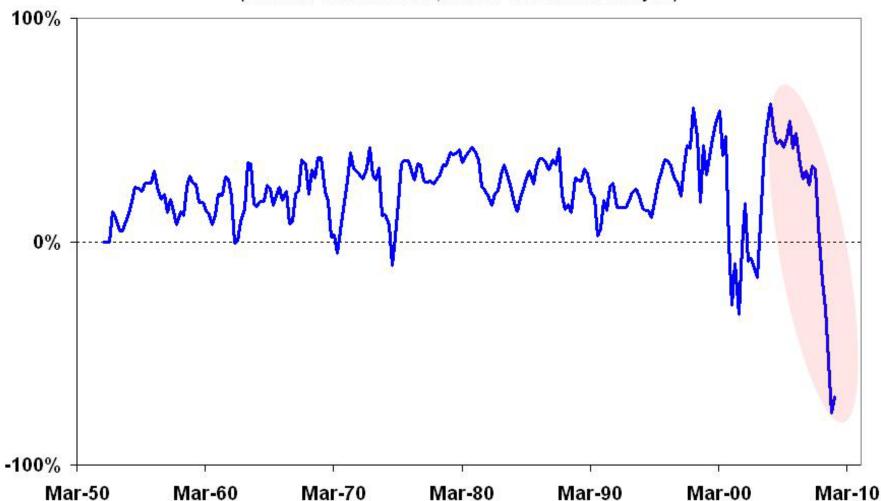
#### THE WALL STREET JOURNAL.

Pittsburgh Pushes Tax on College Students

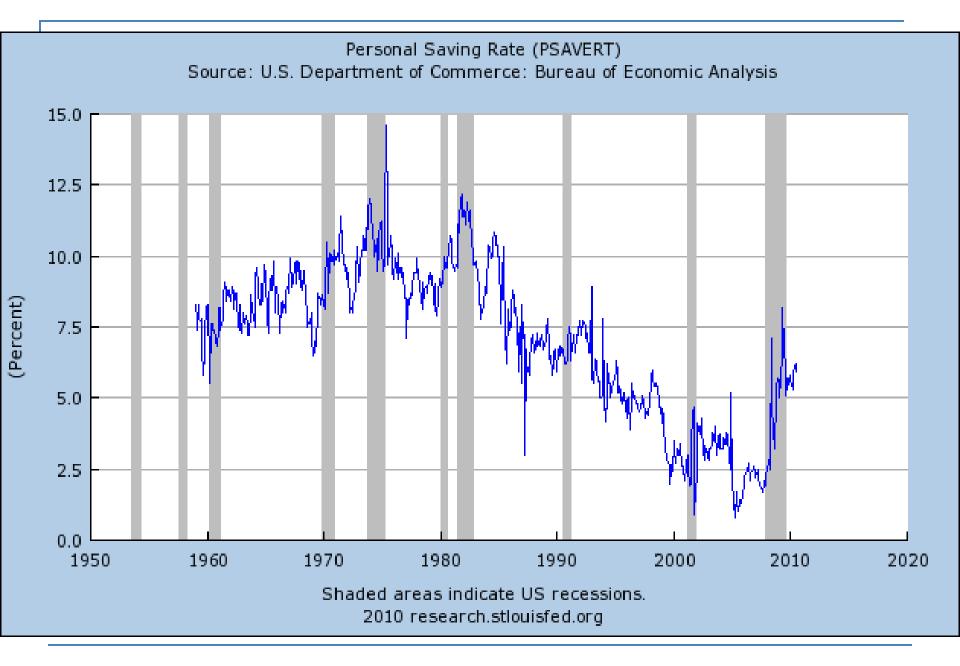


## 12-Month Change in Household Net Worth as a % of Nominal Gross Domestic Product

(Source: Federal Reserve, Bureau of Economic Analysis)

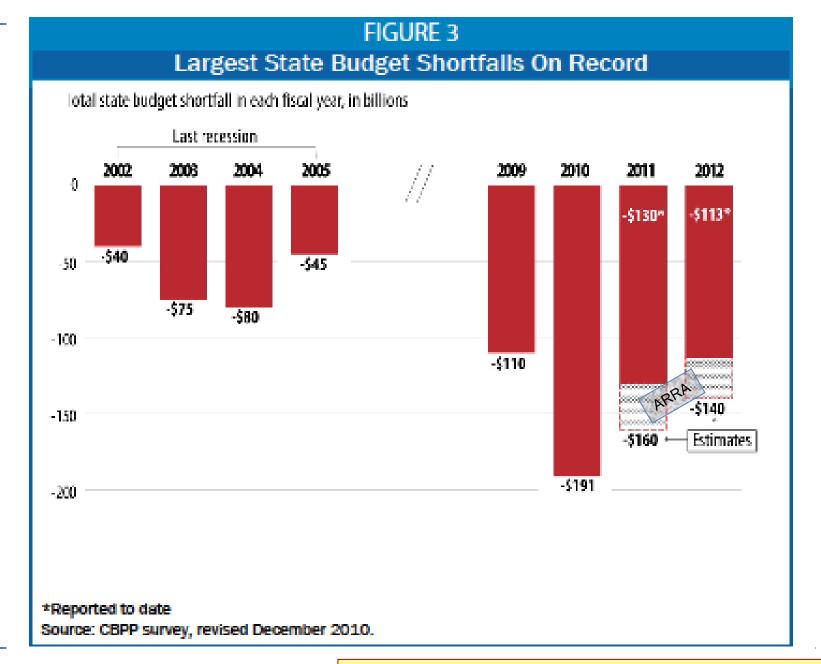
















## The Challenges to Fiscal Leadership

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## NATIONAL | LEAGUE | of CITIES

## of CITIES Research Brief on America's Cities

By Christopher W. Hoene & Michael A. Pagano<sup>1</sup>

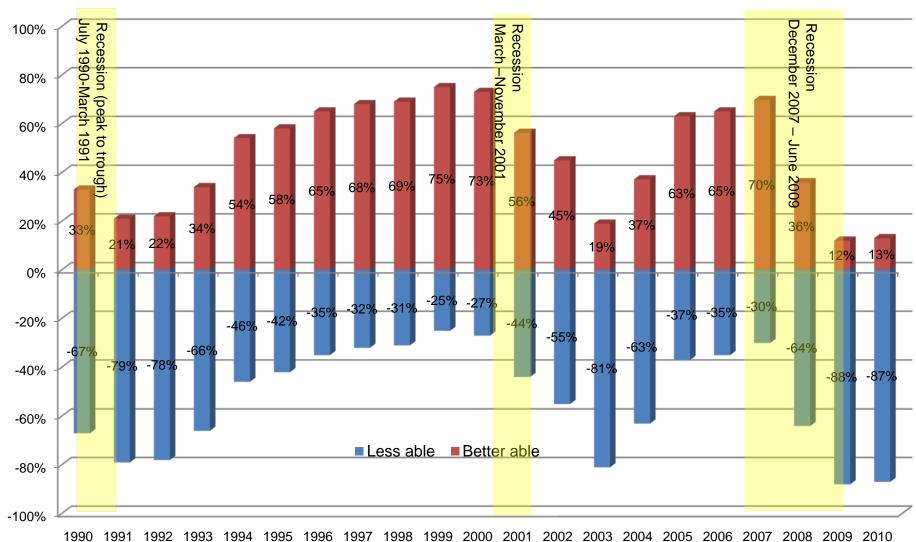
OCTOBER 2010

## City Fiscal Conditions in 2010

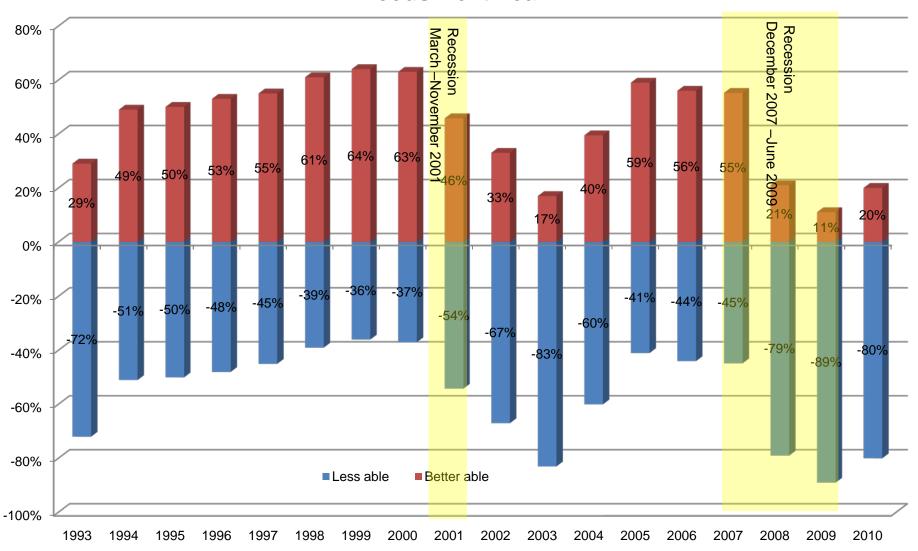
The nation's city finance officers report that the fiscal condition of the nation's cities continues to weaken in 2010 as cities confront the effects of the economic downturn. Local and regional economies characterized by struggling housing markets, slow consumer spending, and high levels of unemployment are driving declines in city revenues. In response, cities are cutting personnel, infrastructure investments and key services. Findings from the National League of Cities' latest annual survey of city finance officers include:

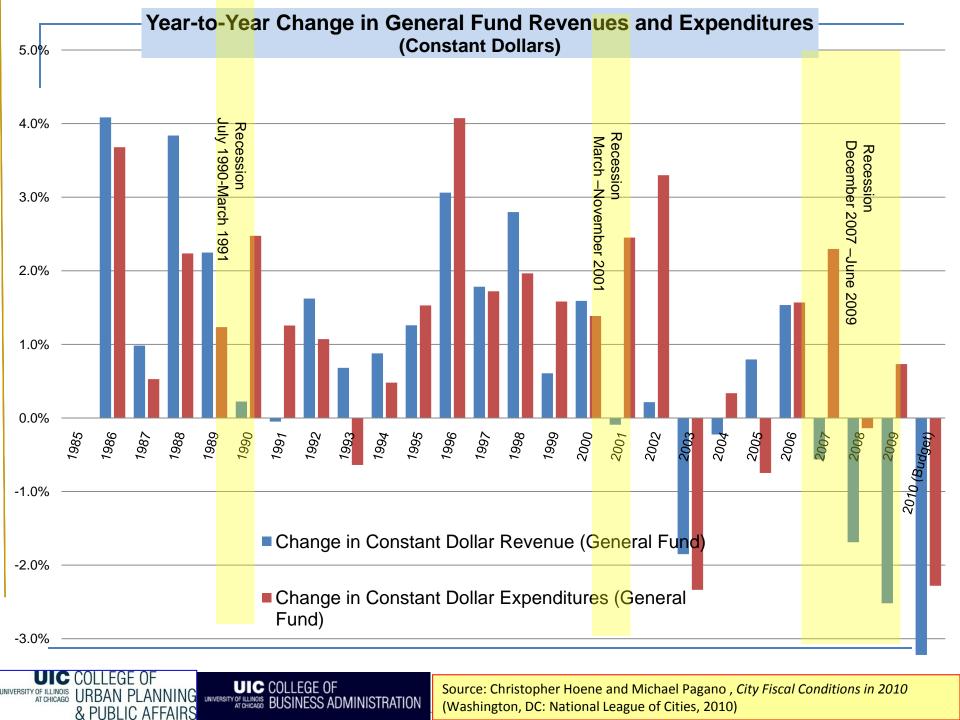
- Nearly nine in ten city finance officers report that their cities are less able to meet fiscal needs in 2010 than in the
  previous year;
- As finance officers look to the close of 2010, they report declining revenues and spending cutbacks in response to the economic downturn;
- Property tax revenues are beginning to decline in 2010, after years of annual growth, reflecting the gradual, but inevitable, impact of housing market declines in recent years;
- City sales tax revenues declined dramatically in 2009 and are declining further in 2010;
- Fiscal pressures confronting cities include declining local economic health, public safety and infrastructure costs, employee-related costs for health care, pensions, and wages, and cuts in state aid;
- To cover budget shortfalls and balance annual budgets, cities are making a variety of personnel cuts, delaying or cancelling infrastructure projects, and cutting basic city services; and,
- Ending balances, or "reserves," while still at high levels, decreased for the second year in a row as cities used
  these balances to weather the effects of the downturn.

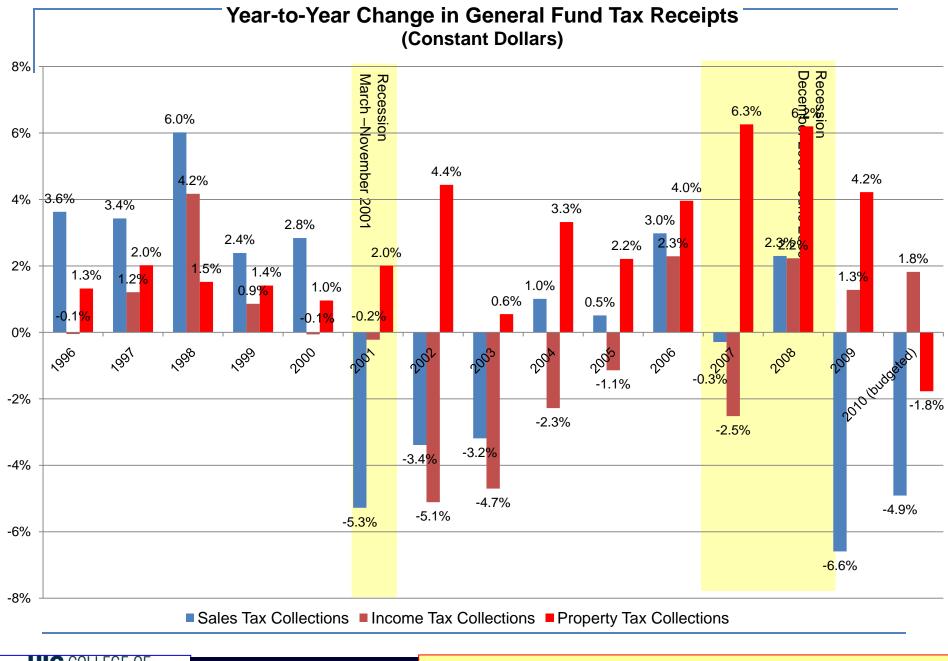
## Percentage of Cities "Better Able/Less Able" to Meet Financial Needs in Current Year

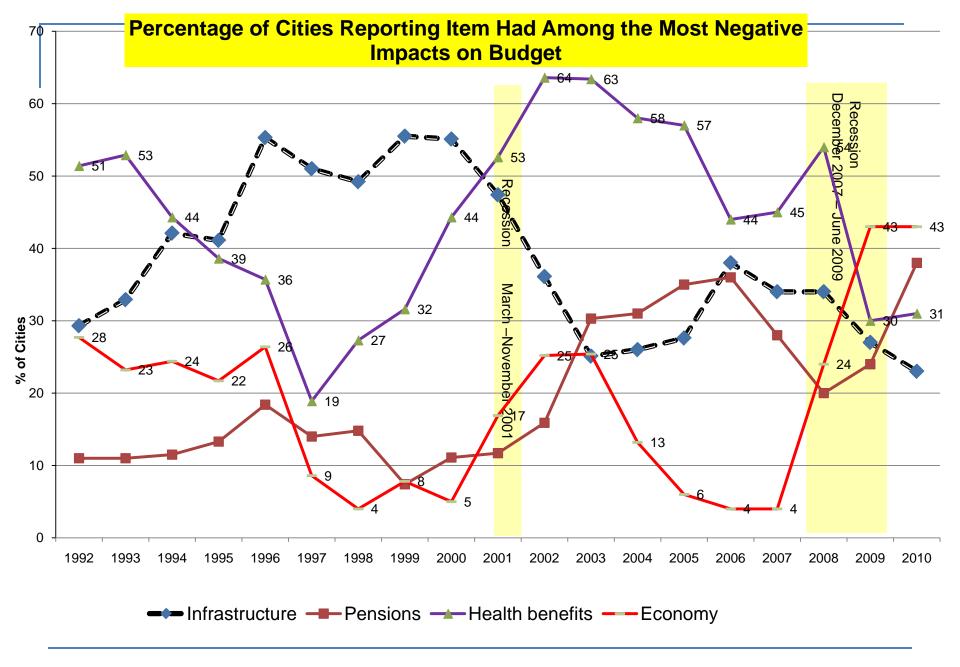


## Percentage of Cities "Better Able/Less Able" to Meet Financial Needs Next Year

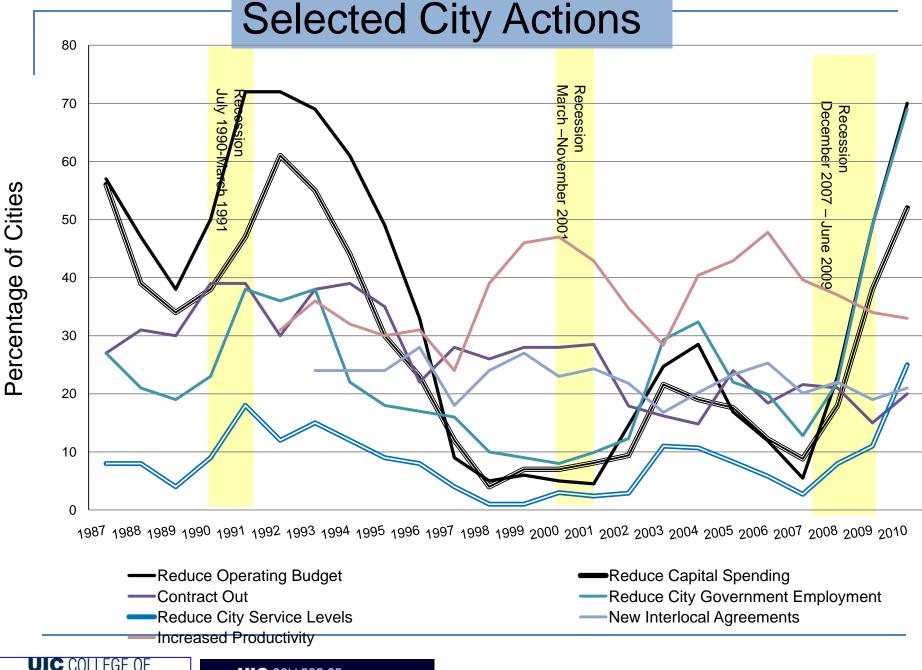






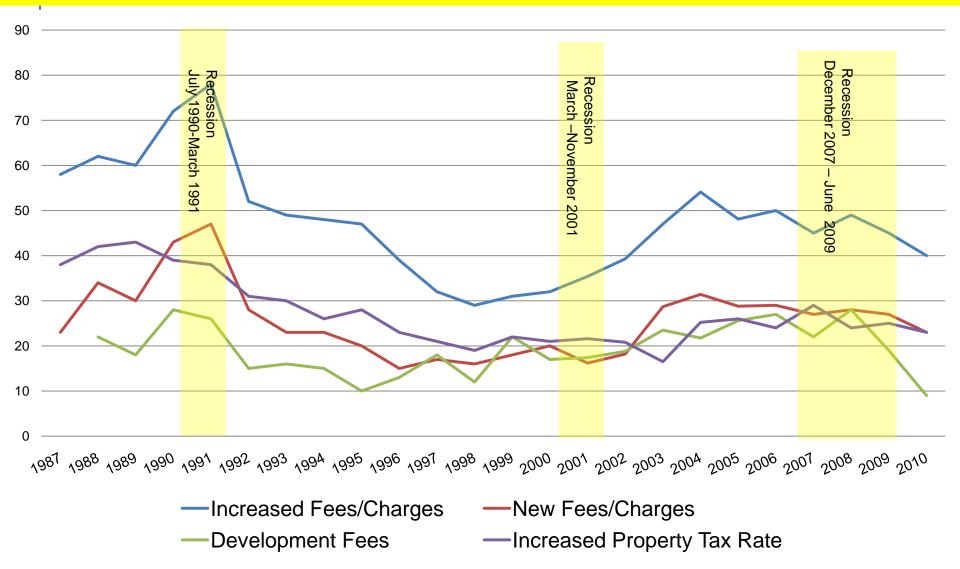








### Percentage of Cities Adopting Fee or Property Increases



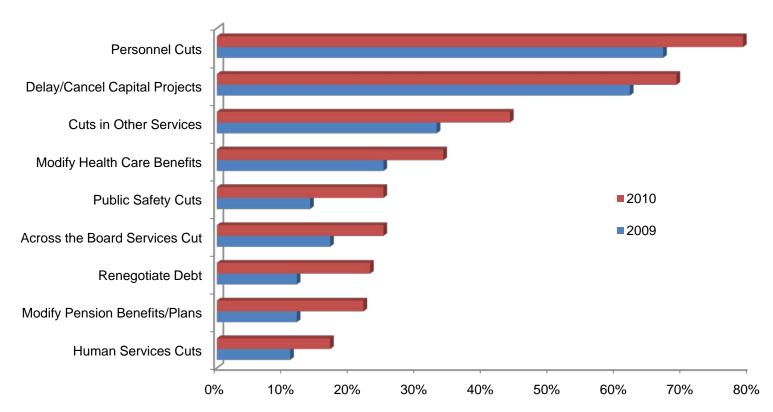


Source: Michael A. Pagano, "Creative Designs of the Patchwork Quilt of Municipal Finance," in Gregory K. Ingram and Yu-Hung Hong, *The Changing Landscape of Local Public Revenues* (Cambridge, MA: Lincoln Institute of Land Policy, 2010), pp. 116-140.

## Expenditure Actions

(% of city finance officers listing factor)

#### City Spending Cuts in 2009 and 2010

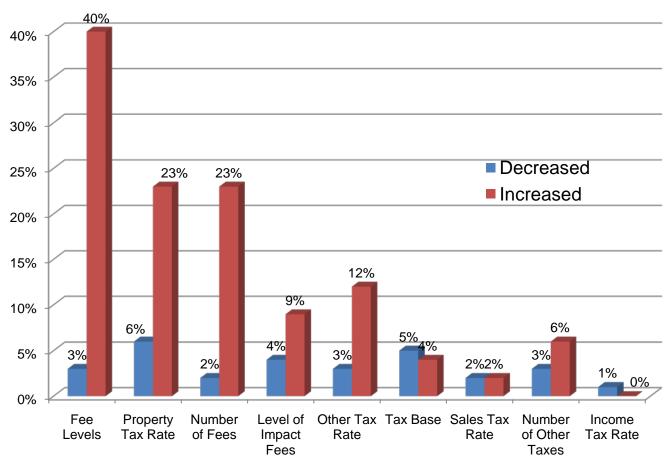




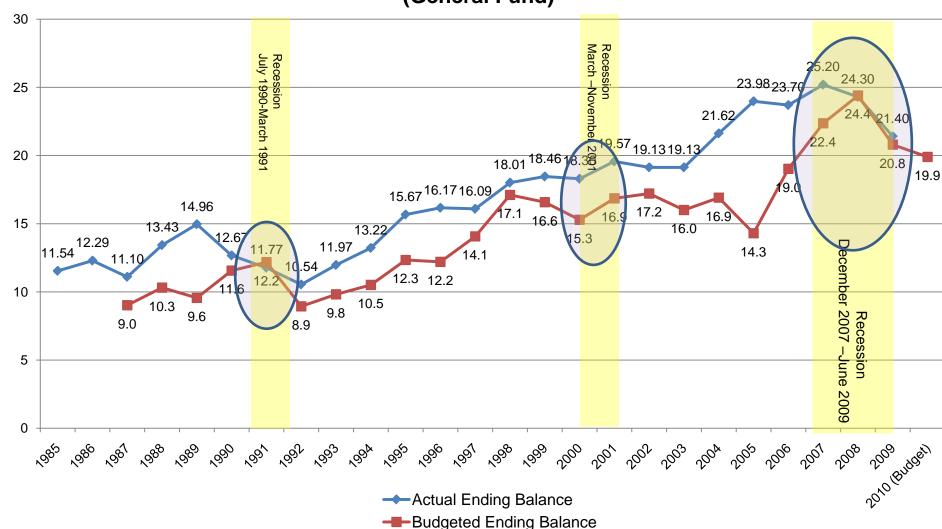
## Revenue Actions

(% of city finance officers listing factor)

#### **Revenue Actions in 2010**



# Ending Balances as a Percentage of Expenditures (General Fund)







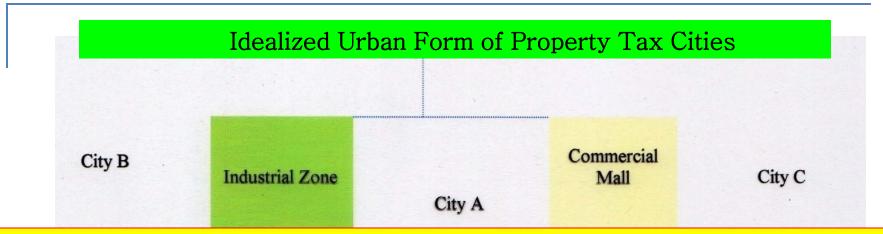
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# Spatialization of Revenue Structures

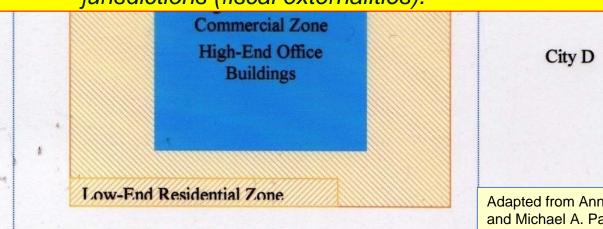
Why promote development or a certain type of development at a particular location?

Given a choice, parcels will be identified for development that maximize revenues or minimize costs. The 'mini-max incentive' embedded within the context of a city's revenue structure manifests itself spatially in the design, land-use designations and development patterns of the city, or the *spatialization of revenue structure*.



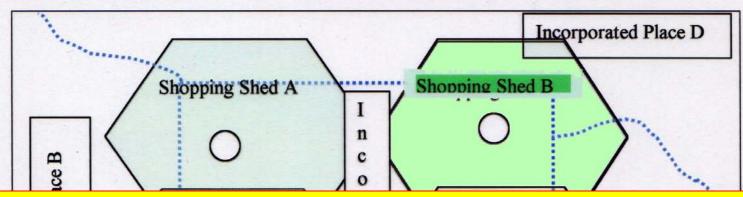
# STRATEGIC BEHAVIOR OF PROPERTY-TAX CITIES

Property-tax cities think strategically about development based on the market value of the development and on the possibility of shifting service-delivery costs to other jurisdictions (fiscal externalities).



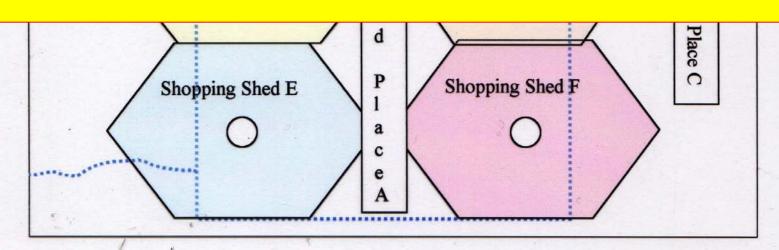
Adapted from Ann O'M. Bowman and Michael A. Pagano, *Terra Incognita: Vacant Land and Urban Strategies* (Georgetown University Press, 2004)

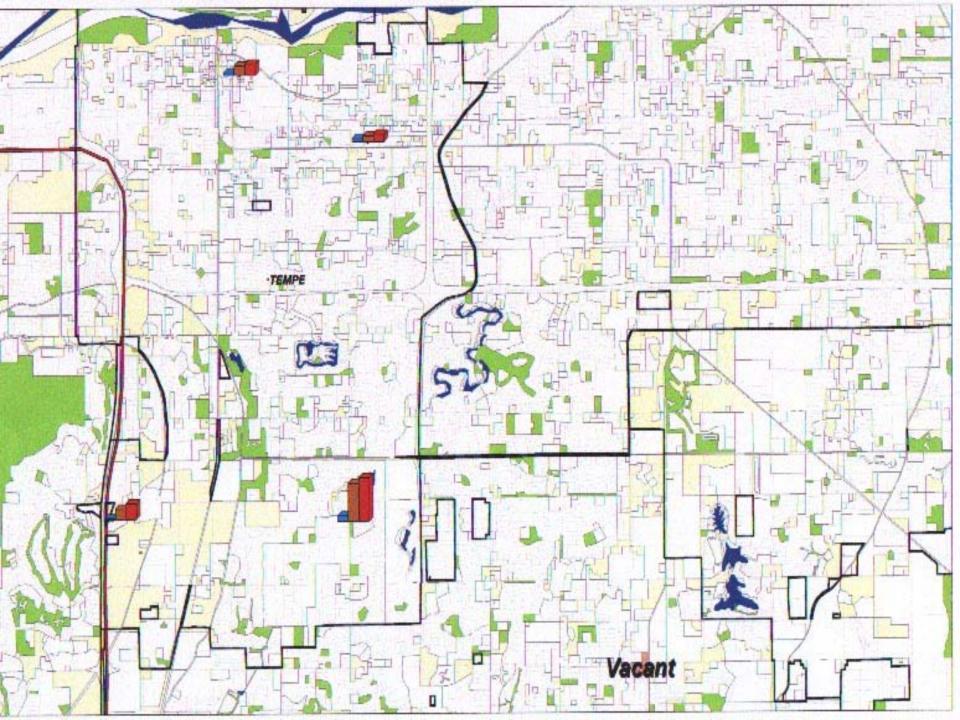
### Idealized Urban Form of Sales Tax Cities

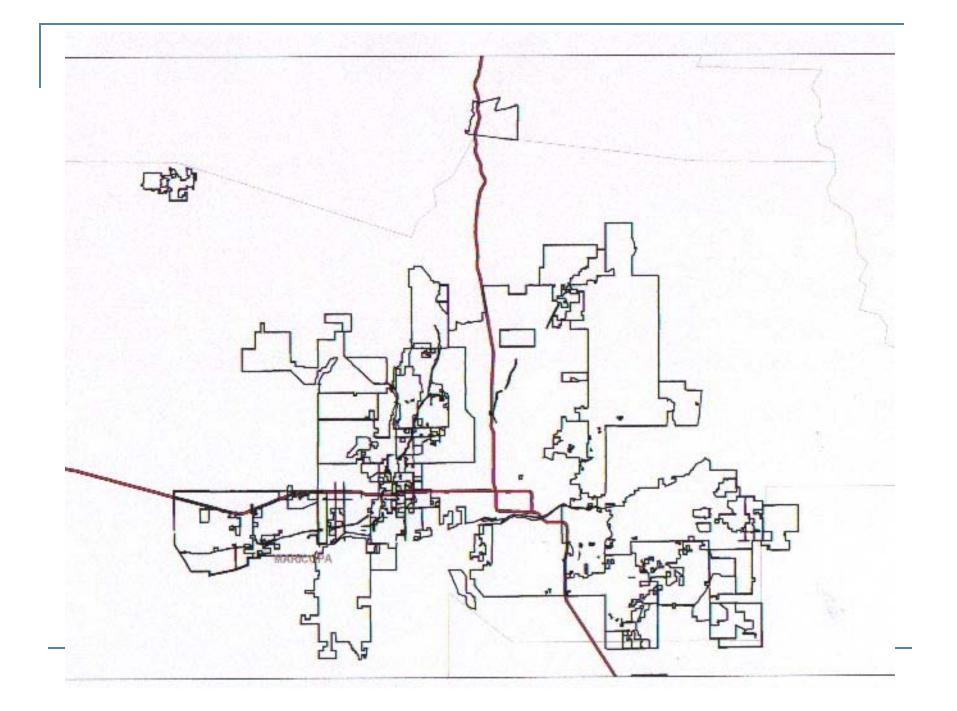


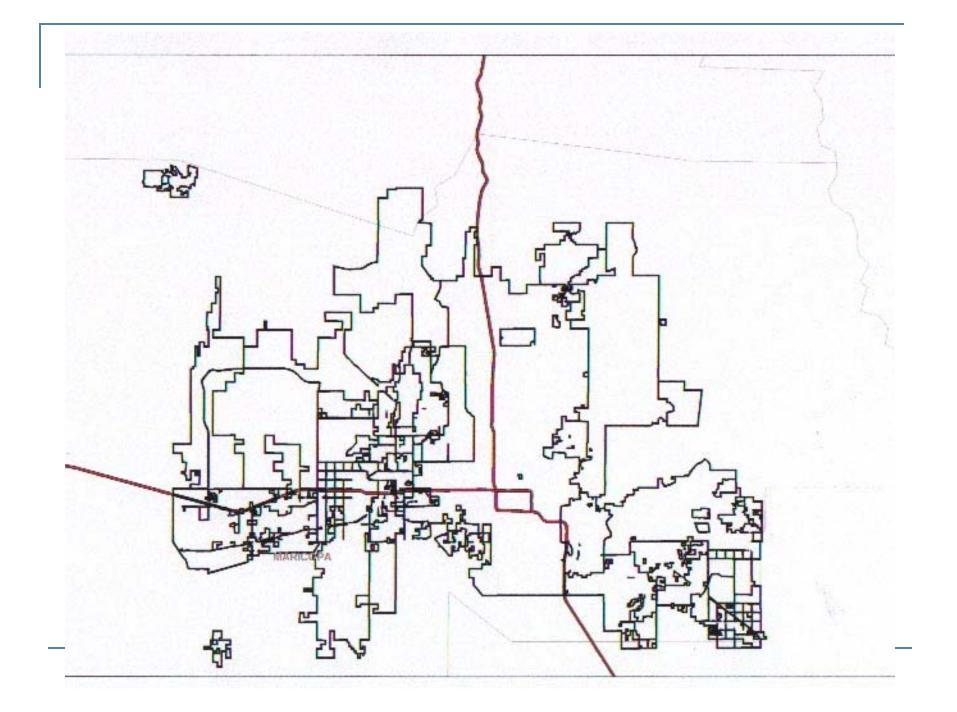
### STRATEGIC BEHAVIOR OF SALES-TAX CITIES

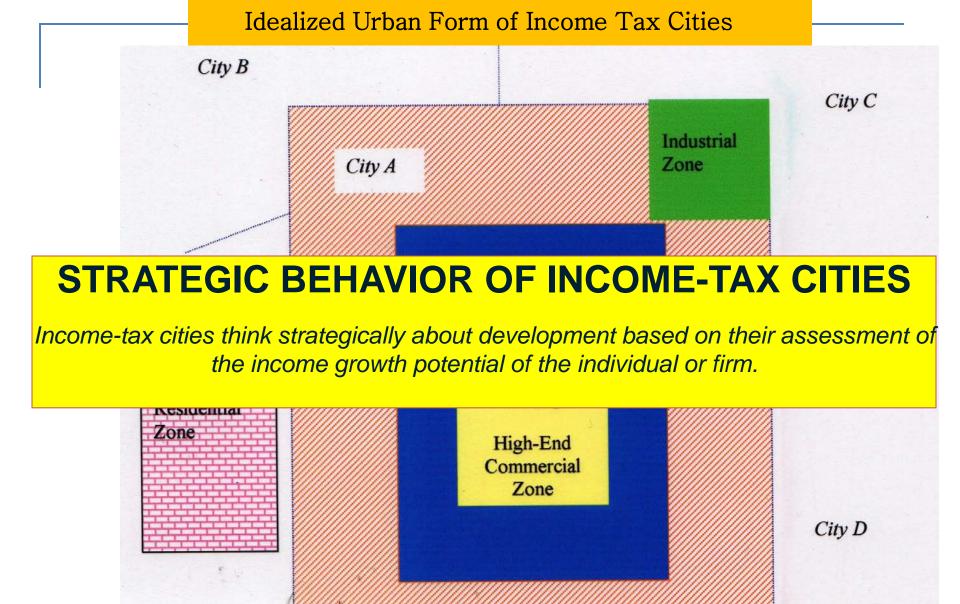
Sales-tax cities think strategically about development based on their mental constructs of "shopping sheds" and on which market transactions are taxable.











Low-End Residential Zone

# Policy Questions?

# 1. Sprawl and transportation.

Low density growth is caused by numerous factors (e.g., transportation and land costs), but might sprawl also be encouraged because of cities' pursuit of revenues. For example, if sprawl is an outgrowth of salestax cities' demand for resources, would a different revenue mix curb or diminish sprawl?

# 2. Regional cooperation.

Do revenue structures influence cooperative behavior among local governments? What immediate gains to a municipality with undeveloped land near it would cooperation with a neighboring municipality generate? Unless forced by the state to adopt a cooperative face, the revenue logic of cities, especially sales-tax cities, might discourage cooperation.

# 3. Revenue Structures and Land Use.

If land use/zoning follows the logic of spatialization of revenue structures, zoning and land use would change with the introduction of a different revenue system.

# The Challenges to Fiscal Leadership

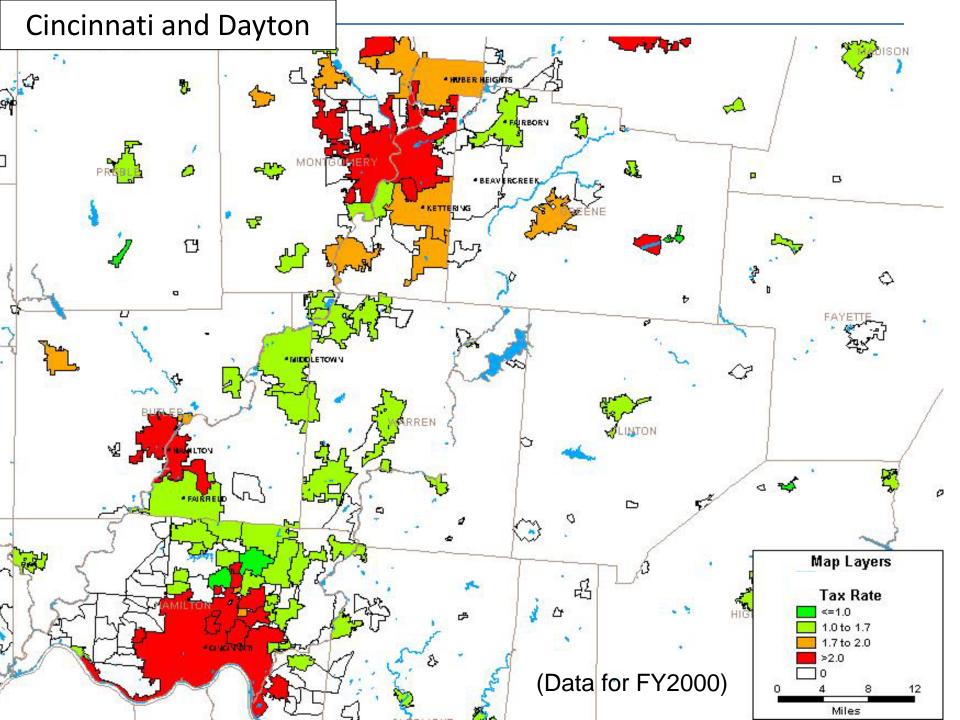
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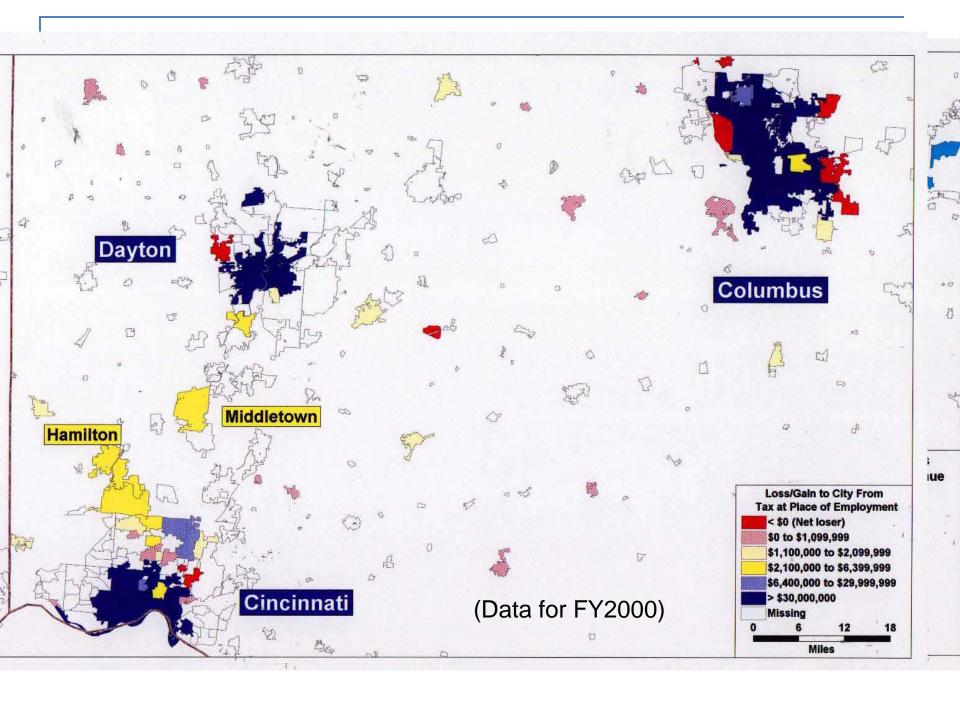
### What to do?

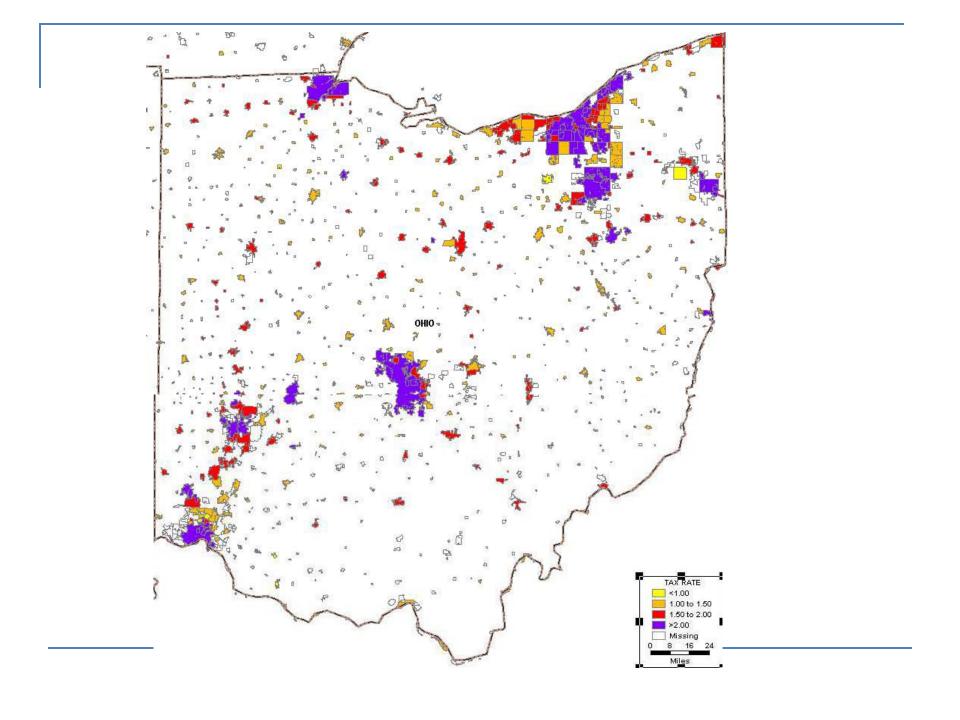
- Don't Waste a Crisis: The economic shock of 2007 to the present ought to encourage a political discourse about reforming the fiscal architecture of municipalities:
  - 1. If States Want Cities to be Responsible for Their Actions, States Should Give Them Adequate Tools. Diversify. Authorize access to taxes. Eliminate TELs.
  - The Fiscal Mismatch Is Weakening Cities. Reform the tax structure: Tax structures might be designed that link closer to cities' underlying engines of growth or to income and wealth.

    Tax on income/wages. Is a tax on income at the place of employment (such as Ohio's, Kentucky's) or a gross receipts tax (such as Washington state's Business and Occupation Tax) a more accurate measure and reflection of a city's tax base?









### Don't Waste a Crisis

Broaden the sales tax base. As the retail sales tax base has narrowed as a percent of consumer spending, is it time to reconsider a sales tax on services?

Restructure the property tax. As real estate loses much of its value, as vacant properties lie fallow, and as the number and value of tax-exempt properties increase, might cities consider moving from a uniform to a split-rate system? What's lost and gained by exempting so much property from the tax roles?

# 3. Jointly Provide Services and Share Service Delivery Costs. The metropolitan region is increasingly the demographic as well as the economic unit of local life and global competitiveness. The new "glocal" nature of regions requires infrastructure delivery at new and flexible scale.

Create regional taxing powers. Municipalities will be looking for regional partners and allies in designing a system that is less destructive to the region's long-term interests and fairer in distributing the costs to the users.

### Don't Waste a Crisis

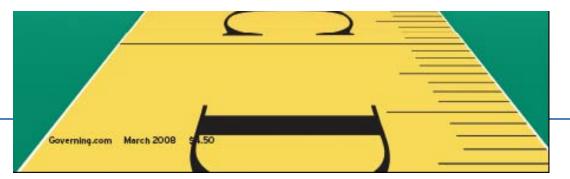
4. Pricing Drives Behavior. Seize It! Cities can create better and innovative financial systems that ensure (1) efficiency is met and the benefits principle followed; (2) equity is met and users pay for services and infrastructure, and an ability-to-pay principle is followed; (3) full-cost pricing of infrastructure construction and operations that include the costs of maintenance into the pricing structure. (The costs of an asset are not only the initial construction costs and later the renovation costs. Operating and maintaining the facility require planning for day-to-day use and adequate funding.)

Approximating the market value of city-delivered services would possibly reduce subsidies to free-riders. Mileage fee? Fee for service?



#### Infrastructure

- The state regularly conducts a thorough analysis of its infrastructure needs and has a transparent process for selecting infrastructure projects.
- The state has an effective process for monitoring infrastructure projects throughout their design and construction.
- The state maintains its infrastructure according to generally recognized engineering practices.
- The state comprehensively manages its infrastructure.
- The state creates effective intergovernmental and interstate infrastructure coordination networks.



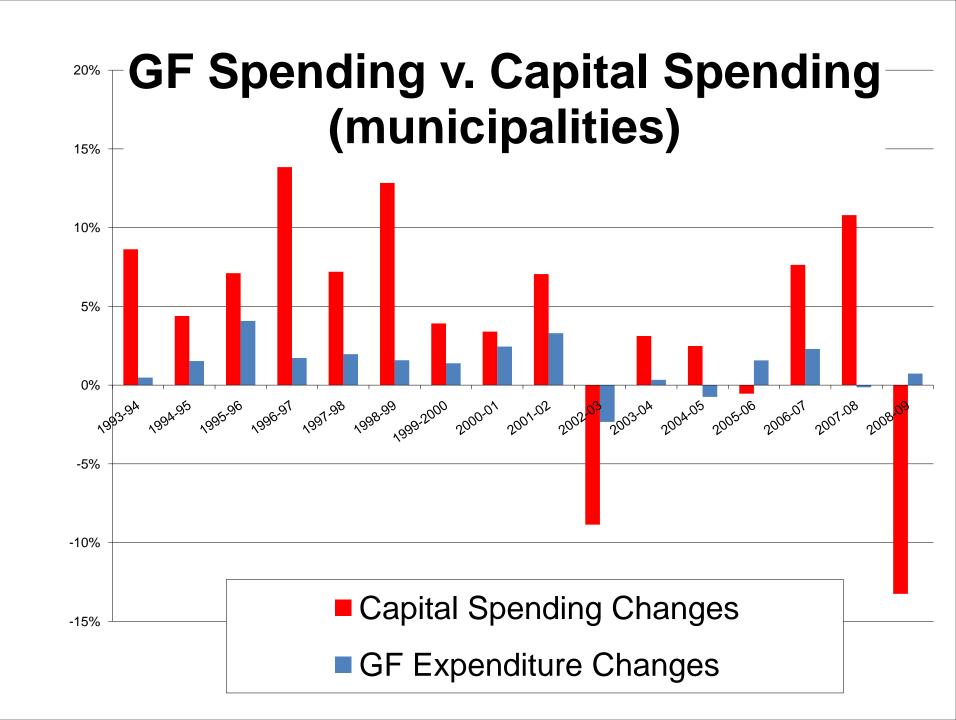


- 3. The state maintains its infrastructure according to generally recognized engineering practices.
  - ✓ The state adopts a life-cycle approach to asset management.
  - √The state employs current condition assessments in setting priorities for infrastructure maintenance and renewals
  - ✓ The state funds maintenance at a level that minimizes a facility's life-cycle costs and that ensures defined levels of service and safety standards are met.



# Infrastructure Criteria Government Performance Project, 2008

Criterion	STRENGTH	MID-LEVEL	WEAKNESS
Planning	10	27	13
Monitoring	11	38	1
Maintenance	7	19	24
Coordination	10	36	4
Intergovernmental	25	25	0



# Crumbling Assets

- First, maintenance is sacrificed in the face of a fiscal slowdown.
- Second, the deferral decision is invisible or undetected in short term.
- Third, budget processes for operating and capital expenditures often are not linked effectively.

5. Revisit the Social Compact. The social compact of the last century that bound generations, socio-economic classes, neighborhoods, cities and regions needs to be reconsidered in light of demographic shifts, the transformation of the underlying economy, the forces of globalization, and an irrepressible resolve to enhance the human condition.

